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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 44

JOHN V. DOBSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 45

E. W. DOBSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 46

ESTATE OF JAMES N. COLLINS, DECEASED, FIRST NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 47

H. J. HARWICK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals in *Estate of James N. Collins* v. *Commissioner* (R. 52–58) is reported in 46 B. T. A. 765, and its opinion in *John V. Dobson* v. *Commissioner* (R. 105–110) is reported in 46 B. T. A. 770. The memorandum opinions of the Board in *Harwick* v. *Commissioner* (R. 9–13) and in *E. W. Dobson* v. *Commissioner* (R. 79–83) are not officially reported.

The opinion of the Circuit Court of Appeals (R. 128–136) is reported in 133 F. 2d 732.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on March 2, 1943 (R. 136–139). The petition for writs of certiorari was filed April 15, 1943, and was granted on June 14, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayers realized losses upon the sales of certain securities which were claimed as deductions in their income tax returns for the years of sale. In three of the cases the taxpayers had net losses in those years; in the fourth case (Harwick) the taxpayer had net income, but available credits against net income relieved the taxpayer of any liability. Some years later claims were asserted

by the taxpayers against the original owners. These claims were settled within the taxable year by cash payments.

The questions are:

(1) Do the recoveries constitute taxable income to the extent that the prior deductions did not result in a "tax benefit"?

(2) If the "tax benefit" rule were adopted, how should the tax benefit be determined?

(3) If the recoveries are taxable, do they constitute ordinary income, or gains from the "sale or exchange" of a capital asset within the meaning of Section 117 (a) (4) of the Internal Revenue Code?

STATUTES INVOLVED

The applicable statutes are set forth in the Appendix, *infra*, pp. 34–38.

STATEMENT

The stipulated facts (R. 18–23 (Harwick), 59–64 (Collins), 84–88 (E. W. Dobson), 118–123 (John Dobson)) in each of the cases were adopted by the Board of Tax Appeals as its findings of fact (R. 9–12 (Harwick), 53–55 (Collins), 79–83 (E. W. Dobson), 105–109 (John Dobson)). They may be summarized as follows:

Some years before the taxable year 1939, the four taxpayers, all residents of Minnesota, had individually purchased stock of the National City Company of New York. Each had sold a portion or all of the stock at losses which were deducted on his income tax returns. (R. 10, 53, 80, 105–106.)

E. W. Dobson, upon the sale of 200 shares in 1930, deducted a loss of $49,302.56 on his 1930 return. The return showed a net loss (after all deductions) of $30,197.56; however, Dobson was properly entitled to an additional loss of $2,350 upon the transaction (R. 80, 81). John V. Dobson, upon his sale of 200 shares in that year, deducted $62,271 on his 1930 return. The return showed a net loss (after all deductions) of $30,043.47 (R. 106, 107). Collins[1] sold 100 shares in 1930 and 1931, respectively, sustaining deductible losses of $41,600.80 for 1930 and $28,163.78 for 1931. He had net losses (after all deductions) of $65,896.51 for 1930 and $40,204.90 for 1931. (R. 53, 63.) Harwick sold 100 shares in 1931 and deducted a loss of $34,451.28 for that year. He reported a net income of $12,042.03, but his return indicated that, due to certain credits, he owed no tax. (R. 10–11.)

At first, the taxpayers considered their purchases and sales of this stock as closed and completed transactions; but several years later they learned that the stock of the National City Company had not been registered in accordance with the requirements of the Minnesota Blue Sky laws. Accordingly, Harwick asserted a claim against the National City Company and the other

[1] Collins died on April 21, 1941, before his case was heard by the Board of Tax Appeals; his executor was substituted as petitioner, but for convenience Collins will be referred to here as the taxpayer (R. 53).

taxpayers filed suits against that company, each contending (1) that the stock had been sold to him without having been registered as required by state law, and (2) that the sales had been fraudulent. In the complaints filed in the three suits, a request was made for a rescission of the sale contracts and there was an offer to turn over the proceeds of the stock sales, or an equal number of shares plus income thereon. (R. 10, 54, 80–81, 106–107.)

The three suits and Harwick's claim were settled in 1939. E. W. Dobson received a total net recovery of $31,432.80 allocable to the stock sold in 1930 (R. 81); John V. Dobson received $32,294.96 allocable to his stock sold in 1930 (R. 107); Collins received a net of $23,296.45 allocable to the stock sold in 1930 and $6,454.18 allocable to the stock sold in 1931 (R. 54). Harwick received $17,000 (R. 10). In all four cases costs of the stock exceeded the sums received on the sales in 1930 plus the recoveries in 1939.

Neither E. W. Dobson, John V. Dobson, nor Collins reported any of these recoveries as income for 1939 (R. 55, 82, 108). Harwick reported $9,884.22, conceding that he had recovered a tax benefit in that amount from the deduction in 1931 (R. 10). Throughout the year 1939 adjustment of the liabilities for 1930 and 1931 was barred by the statute of limitations (R. 54, 82, 108).

The Commissioner transferred the entire amounts of the recoveries to income. The Board

ruled that they were subject to tax only to the extent that they exceeded the amounts by which the prior allowable deductions had not offset taxable income. Accordingly, in the case of E. W. Dobson, the Board reversed the Commissioner since the recovery was less than the net losses in the prior year (R. 83). Similarly, in the case of Collins, the Board reversed since upon its theory no part of the prior deductions offset gross income (R. 58). In the case of John V. Dobson, the Board held that the recovery was taxable to the extent that the 1939 recovery exceeded the net loss for 1930 (R. 109–110). In the case of Harwick, the Board held that since he reported net income after all deductions in 1931, the loss deduction in that year had resulted in a tax benefit, and therefore the entire amount recovered in 1939 should be included in his gross income (R. 12–13). The Board further held in these latter two cases that the income was taxable as ordinary gain (R. 13, 110).

The Circuit Court of Appeals sustained the Board in the Harwick case, and reversed in the other three, holding that in each case the entire recovery was taxable as ordinary gain whether or not the prior deductions had resulted in a tax benefit (R. 130–136).

SUMMARY OF ARGUMENT

1. The principal question in this case turns on the application of the settled principle that the single

year is the unit of taxation. The taxpayers' claims, upon their disposition by settlement in 1939, had a basis of zero for determining gain or loss. This results from the adjustments required by the receipts and losses allowable upon the sales of the stock in prior closed years under the relevant provisions of the statute and the rule established by *United States* v. *Ludey*, 274 U. S. 295. The investment was closed out in those earlier tax years. Consequently, the entire proceeds of the settlement constituted "gain" and hence "income" within the year 1939. It is immaterial, as in the case of adjustments to basis for prior depreciation or depletion "allowable," that the years in which taxpayers were entitled to the deductions were net loss years. It is also immaterial, under *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, that the over-all transactions may have resulted in losses.

The statute allowed the taxpayers an opportunity to recoup their investment tax-free in the prior years. In the absence of specific statutory authority such as that provided by the loss carry-over provisions or by the new special provisions of Section 116 of the Revenue Act of 1942 relating to bad debts, prior taxes, or delinquency amounts, there is no reason why the circumstance of the subsequent recovery should entitle them to a second opportunity which would not otherwise be available. The legislative history of Section

116 itself shows plainly that Congress did not regard the tax benefit theory as part of the law.

A further argument against the tax benefit rule is presented by the problem of how the presence or absence of a "tax benefit" should be determined. There would clearly be no warrant for going as far as the taxpayers who urge that there must be a dollar tax advantage. If the deductions here in fact offset gross income, the original investment unquestionably had been recouped in the prior year, although available credits would in any event have relieved the taxpayers of any tax liability. Moreover, it cannot be assumed that these loss deductions were deducted from gross income only after all other deductions or credits had been taken. All deductions must have contributed proportionately in producing the net losses. But this would lead to conflict with the legislative intention that the deductions specifically covered by Section 116 should be deemed to have been the last deducted. The potential conflict is substantial additional evidence that Congress regarded the tax benefit rule as inapplicable in any situation except that expressly dealt with by it.

2. The proceeds of the settlement plainly constituted ordinary income, rather than gain from the "sale or exchange" of a capital asset. The compromise cannot appropriately be characterized as a sale or an exchange. The taxpayers' claims were extinguished; they were not transferred. Cf.

Helvering v. *Flaccus Leather Co.*, 313 U. S. 247; *Fairbanks* v. *United States*, 306 U. S. 436. The facts do not justify the attempt to regard the settlement as a receipt from the sale of the stock to third parties in the earlier years.

ARGUMENT

I

THE COURT BELOW CORRECTLY HELD THAT THE PROCEEDS OF THE SETTLEMENTS CONSTITUTED TAXABLE INCOME.

This Court, in *Griffiths* v. *Commissioner*, 308 U. S. 355, held that where securities were sold and a loss allowed, payments subsequently received in settlement of a fraud claim asserted against the original vendor were income in the later year. The principal question here is whether a different rule should apply where the taxpayer's returns for the earlier year, in which the securities were sold and the loss realized under the statute, showed a net loss. The court below held not, and we think the decision was clearly correct.

We start with the settled proposition that the single year is the unit of taxation. Income is computed on the basis of an annual accounting for gains and losses realized, i. e., on the basis of transactions closed within each taxable year. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 326; *Virginian Hotel Corp.* v. *Helvering*, No. 766, 1942

Term.[2] These taxpayers, at the beginning of the tax year 1939, held claims against their vendors. Within that year they disposed of the claims by settlement. The problem is whether the funds thus realized from the settlement constituted "gain" and hence "income" measured by the transactions occurring *within the year 1939*. The answer necessarily turns on the basis of the claims for tax purposes. Cf. *Elverson Corp. v. Helvering*, 122 F. 2d 295, 297 (C. C. A. 2d); *Helvering v. Roth*, 115 F. 2d 239, 241 (C. C. A. 2d). Our view is that their basis was zero, and that consequently the entire recovery was income. This follows from the application of the relevant statutory provisions and from the principles established in *United States* v. *Ludey*, 274 U. S. 295.

1. Supplementing the broad definition of gross income contained in Section 22 (a) of the Code, Section 22 (f) (Appendix, *infra*) provides that upon "sale or other disposition of property, the gain or loss shall be computed as provided in section 111." Under Section 111 (a)

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[2] Treasury Regulations 103, Section 19.43-2, issued under the Internal Revenue Code provide: "The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year." The same language appears in regulations issued under prior Revenue Acts including those in force in the years when the taxpayers sustained their losses on the sales of the stock. See, e. g., Treasury Regulations 74, Article 342, issued under the Revenue Act of 1928. The Circuit Court of Appeals regarded the taxpayers' position in the instant cases as inconsistent with this regulation. (R. 132.)

(Appendix, *infra*) the gain from the sale "or other disposition of property" is the excess of the amount realized over the adjusted basis provided in Section 113 (b). Section 113 (b) specifies the adjustments to be made to the basis determined under subsection (a), that is, to the cost basis, subject to exceptions which are not here material. Under paragraph (1) of subsection (b), proper adjustment must be made, *inter alia*, "(A) for expenditures, receipts, *losses*, or other items, properly chargeable to capital account" [italics supplied], and under clause (B) for depreciation and depletion "to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws."

The theory of the statutory provisions is evident. It is fundamental that gain upon the disposition of a capital item is taxable to the extent that it exceeds the unrecovered investment. Therefore any capital expenditures must be added to the original cost in order to reflect the full investment made by the taxpayer. Conversely capital receipts representing prior tax-free returns of capital must first be deducted in order to prevent a second exclusion from gross income. Similarly, losses chargeable to capital account and depreciation or depletion charges reflect a prior disposition of the assets for which the statute allows a deduction. The right to a deduction for loss of capital is treated as the equivalent, for tax purposes, of a prior capital

return in computing the gain realized upon subsequent disposition of the remaining property interest.

In 1930 and 1931, the taxpayers upon the sale of their shares had had a portion of their original capital investments returned to them in the form of cash and had realized deductible losses covering the balance. These were closed transactions. The losses could be taken only in those years. The subsequent discovery of the claims against the original vendors showed that the taxpayers still retained a property interest arising from the original purchases of the shares. But we think it clear that in determining the basis of the claims both the language and the theory of Section 113 (b) (1) (A) requires an adjustment for the receipts and the losses realized upon the sales of the shares in the prior years.

The statute says nothing of prior "tax benefits". Prior capital receipts are properly deducted from the basis, although in the year of their receipt the taxpayer may have had sufficient deductions so that the exclusion of the receipts from gross income resulted in no actual tax advantage. There is no suggestion that comparable deductions allowable in the prior years are to be treated differently. To the extent of these exclusions or deductions the transaction has been closed in the prior years. There has been an accounting between the Government and the taxpayer in those years. The investment has been terminated for

tax purposes and the rights determined accordingly. A second opportunity to take the exclusions or the deductions to which the taxpayer was entitled is not afforded upon a later disposition of the property still retained.

The *Ludey* case, *supra*, is a judicial recognition of the validity of the theory underlying these provisions. The question there was the basis for determining gain realized upon the sale of depletable property. The Court held that the original cost basis should be reduced by the amount of depletion allowable in prior years, although the taxpayer had claimed less in his returns, and although the deductions allowable might be less than the depletion in fact sustained. The proceeds of the sale in excess of that depleted cost were classed as income.

The fundamental nature of the decision is emphasized by the fact that the result did not depend upon an express statutory provision for adjustment of basis upon sale of property, such as that now contained in Section 113 (b) of the Code. The Court treated depreciation and depletion allowances as representing the loss of capital investment on the theory that "by using up the plant, a gradual sale is made of it" (p. 301). The cost thus previously deductible must be eliminated from basis in order to determine the cost of the remaining property sold within the taxable year. The fact that the deductions were not claimed is immaterial, since the taxpayer cannot choose the

year in which he will take a deduction. The Court considered the right to the deduction provided by the statute as intended to be regarded as a return of capital; in answering the contention that the deduction for depletion was allowed as a special bonus for enterprise and willingness to assume risks and should not be regarded as reducing the investment, the Court said (pp. 302–303):

> The Corporation Tax Law of 1909 had failed to provide for any deduction on account of the depletion of mineral reserves. *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116; *Goldfield Consolidated Mines Co.* v. *Scott*, 247 U. S. 126. The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on account of depletion in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks.

In the *Ludey* case, to be sure, it does not appear that the prior years, for which the depletion deductions were allowable, were net loss years. The

decision, however, implicitly rejects the theory that the taxpayer must have received a tax benefit from the allowances before they can be treated as a return of capital in the prior years; for it was held immaterial that the taxpayer had failed to claim the full amount allowable in its prior returns. The decisive fact was that the statute had recognized a prior disposition of a portion of the property in the prior years and had allowed the taxpayer an opportunity in those prior years for a *pro tanto* recovery of its investment tax-free. Thus subsequent decisions have consistently held that the basis for determining gain upon the sale of property must be reduced by prior depreciation or depletion "allowable" regardless of any question of prior tax benefit. *Hardwick Realty Co.* v. *Commissioner*, 29 F. 2d 498 (C. C. A. 2d); *Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318 (C. C. A. 2d); see also *Kittredge* v. *Commissioner*, 88 F. 2d 632 (C. C. A. 2d); *Herder* v. *Helvering*, 106 F. 2d 153, 162 (App. D. C.), certiorari denied, 308 U. S. 617; *Jones* v. *Commissioner*, 72 F. 2d 114 (C. C. A. 8th). In the recent case of *Virginian Hotel Corp.* v. *Helvering, supra*, the opinion of the majority, which cited the *Beckridge* case, was predicated upon this assumption, and the dissenting opinion of the Chief Justice expressly negatived any intent to imply that "allowable" depreciation, whether deducted from the gross income or not may not properly be used to reduce basis. Noth-

ing in the dissenting opinion of Mr. Justice Jackson was to the contrary.

The taxpayers in the instant case are in a position wholly comparable with that of an owner of depreciable property which has been fully depreciated. Both own property upon which the original investment has been closed out for tax purposes. Under the statutes, both have been intitled to deductions equalling the otherwise unrecovered cost of their investment. Like fully depreciated property, the taxpayers' claims thus have a zero basis.[3]

2. The taxpayers argue that gain or loss upon the disposition of capital, in contrast with the recognition of ordinary income or the allowance of deductions for ordinary business expenditures, should not be determined by events occuring in a single tax year, but upon the transaction as a whole. (Br. 20–23.) Their entire case rests upon this proposition. We think it fundamentally wrong. The theory of the single tax year is basic in our income tax system, and there is no justification for drawing the distinction urged.

[3] The taxpayers refer in their brief to the fact that in the *John V. Dobson* case, the Commissioner did not press before the Board of Tax Appeals the taxability of the portion of his recovery allowable to shares sold in 1931 upon which no loss had been claimed. (Br. 29, R. 110.) This was in accord with the administrative position which was taken with respect to bad debts in view of provisions found in the regulations since 1921. This ruling on bad debts was based on considerations of administrative fair play; it expressly noted that the *Ludey* decision indicated the contrary result. G. C. M. 22163, 1940-2 Cum. Bull. 76.

The *Ludey* case, of course, gave full recognition to the application of the principle to capital transactions, as have the cases, discussed above, which hold that basis must be reduced by prior "allowable" depreciation whether or not the prior years were loss years.[4] Although *Burnet* v. *Stanford & Brooks Co., supra,* did not involve capital transactions in the ordinary sense, the decision necessarily leads to the same conclusion.

In the *Sanford & Brooks Co.* case, the taxpayer had undertaken to perform a dredging contract with the United States during the tax years 1913 to 1916. It added to its gross income the payments made under the contract for those years and deducted the expenditures. The expenditures were greatly in excess of the receipts, and the returns for three of the four years showed net losses. Subsequently, suit was brought in the Court of Claims against the United States for breach of warranty, and in 1920 the taxpayer recovered the amount by which its expenditures had exceeded its receipts. The transaction as a whole had not shown a profit, and the returns in

[4] In *Beckridge Corp* v. *Commissioner, supra,* the court said (p. 319): "Without repeating the discussion in the *Hardwick* case, it will suffice to say that the petitioner's argument misconceives (1) the theory of depreciation as explained in *Ludey* case and (2) the theory of annual accounting which may produce a taxable profit in one year even though a loss sustained in another makes the whole transaction nonprofitable. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383."

three of the four prior years for which the expenditures were deductible showed net losses. Nevertheless, the Court sustained the inclusion of the recovery in the taxpayer's gross income for that year.

Two propositions were settled by the decision: (1) Gain or loss is properly ascertained on the basis of a fixed annual accounting period, and income computed annually as the net result of all transactions within the year is properly taxable although there may have been a loss on the overall transaction; (2) deductions attributable to such a transaction which are allowable in prior years cannot, in the absence of specific statutory authority, be carried over to offset the income realized in the later year although the prior years were net-loss years. We can perceive neither logical basis nor practical reason for a departure from the application of these principles to cases involving the disposition of capital items.

We think a different conclusion is not indicated by the Court's statement that, "They [the expenditures on the contract] were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See *Doyle* v. *Mitchell Brothrs Co.* [247 U. S. 179, 185]" (p. 364). The thought underlying this statement, as we understand it, was that if these were capital expenditures

they would properly have been added to basis at the time made rather than being deducted as a business expense. On this assumption, the taxpayer, at the time of recovery, would not have had any prior right to recoup the investment, and therefore it would have been necessary to allow a recoupment from the recovery before any gain was realized. The Court neither said nor implied, however, that if the statute has once given a taxpayer the right to deduct a capital expenditure, a second deduction must be allowed before gain is recognized if the first did not result in a tax advantage. We think the Court did not intend to give deductions for capital losses a special status different from the deductions for business expenditures and ordinary losses.[5]

The taxpayers here have suffered from the misfortune that sometimes results from the single year theory of income taxation. The deduction, attributable to this transaction, was allowable in a year when apparently other deductions or credits

[5] The taxpayers rely on the decision in *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, where it was held that a reduction in an indebtedness did not constitute income where the borrowed funds had previously been expended on projects productive of losses in excess of the debt reduction. But to the extent the opinion contains language intimating that gain under the Sixteenth Amendment must be measured on a transactional basis, the case must be regarded as having been disapproved by the decision in *Burnet* v. *Sanford & Brooks Co.*, *supra*. See Magill, *Taxable Income*, 212, 215, 219–226.

were sufficient to consume most or all of the taxable income of that year. The proceeds were received in a later year of insufficient deductions or credits. From a practical standpoint, the taxpayers are in a position identical with that of the taxpayer in *Burnet* v. *Sanford & Brooks Co., supra.*[6] As we have emphasized, under the statute a taxpayer is given one opportunity to deduct an expense or to recoup a lost capital investment; that opportunity is in the year of realization. Specific statutory authority is required before another opportunity can be claimed.

Congress has dealt with the problem of "lost" deductions in the loss carry-over provisions of the

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[6] The principle of the single tax year does not mean that facts occurring in past years are not considered at all in determining the tax consequences of transactions closed in the current year. They have to be. In *Burnet* v. *Sanford & Brooks Co., supra*, the fact that the recovery constituted "gross income" depended upon a knowledge of the nature of the contract and work in prior years from which the recovery arose. In any case involving the disposition of property, it is necessary to know what the taxpayer started with at the beginning of the year in order to measure his gain within the year.

The import of the principle is that the taxpayer's gain or loss for each taxable year must be determined, and each taxable year closed, solely on the basis of the income realized and the deductions allowable within that year. Thus, in *Burnet* v. *Sanford & Brooks Co.*, the expenditures made incident to the contract in prior years could not be deducted from the income of the later taxable year. Similiarly in *United States* v. *Ludey, supra*, depletion allowable in earlier years had to be eliminated from basis in determining the unrecovered cost of the property sold in the later taxable year since it represented the equivalent of a return of capital in the prior year.

various revenue laws.[7] Within those carefully circumscribed situations, further opportunities are afforded to take deductions which had proved valueless in other years. If the taxpayers here were entitled to the benefit of such provisions, they would have been entitled to a further opportunity to deduct their losses realized in 1930 and 1931. Since this relief was not available under the statute, they now seize upon the circumstance that in a future year unexpected additional proceeds were recovered from the property to justify another opportunity to recoup the lost investment by an exclusion from gross income.

This, in true practical effect, is the "tax benefit" argument. We can perceive no reason why the

[7] The Revenue Act of 1928, Section 117 (b), authorized a limited two-year net loss carry-over. In the Revenue Act of 1932, Section 117 (b) and (d), the carry-over was limited to one year. See H. Rep. No. 708, 72d Cong., 1st Sess., p. 23 (1939–1 Cum. Bull. (Part 2) 457, 473). Loss carry-over was eliminated by the National Industrial Recovery Act, c. 90, 48 Stat. 195, and not restored to the Revenue Acts until enactment of the Revenue Act of 1939, amending the Internal Revenue Code. See H. Rep. No. 855, 76th Cong., 1st Sess., p. 9.

Section 211 (a) and (b) of the Revenue Act of 1939 c. 247, 53 Stat. 862, added provisions for net operating loss carry-over to the Internal Revenue Code (Sections 23 and 122). A two-year carry-over is provided subject to certain restrictions. See also Section 117 (e) of the Internal Revenue Code authorizing a capital loss carry-over against capital net gains for the succeeding five years.

Section 153 of the Revenue Act of 1942, c. 619, 56 Stat. 798, amended the Internal Revenue Code (Section 122 (b)) by adding a provision authorizing a two-year net operating loss carry-back.

circumstance of the subsequent recovery should provide the basis for a judicial exception to the general rule. There is no right to recoup tax-free last year's losses from this year's income. The merchant whose capital investment is impaired by losses one year has no right to recoup that lost capital free from income tax the following year or years. Under *Burnet* v. *Sanford & Brooks Co., supra,* as we have emphasized, a taxpayer is not entitled to offset last year's expenditures from this year's income merely because they are both attributable to the same transaction. It would be anomalous to allow the taxpayers the relief they seek when it is denied in these wholly comparable situations.

3. An essentially similar question has arisen in cases where taxpayers have recovered upon debts which had been charged off as worthless in a prior year and where the prior deduction had resulted in no "tax benefit." Funds received in satisfaction of a debt, of course, ordinarily constitute a capital reimbursement of an investment. The Circuit Courts of Appeals for the Third and Fourth Circuits, however, have both held that in view of the prior deductions the recovery constitutes taxable income regardless of tax benefit. *Commissioner* v. *United States & Int. Sec. Corp.,* 130 F. 2d 894 (C. C. A. 3d); *Helvering* v. *State-Planters Bank & Trust Co.,* 130 F. 2d 44 (C. C. A. 4th). The court below cited these cases in sup-

port of its position. Cf. also *National Bank of Commerce* v. *Commissioner*, 115 F. 2d 875 (C. C. A. 9th).*

Following these decisions, Congress, in the Revenue Act of 1942, provided by specific statutory enactment that upon the recovery of bad debts, prior taxes, or "delinquency amounts," that portion of the prior allowance which did not result in a tax reduction should be excluded from gross income. Revenue Act of 1942, Section 116. It is abundantly clear, however, that Congress regarded the rule it was overturning as inexpedient in these three situations rather than erroneous under the previous law. The recommendation for the statutory change first appeared in a Statement by Randolph Paul, Tax Advisor to the Secretary of the Treasury, before the Ways and Means Committee of the House of Representatives on March 3, 1942. This Statement expressly recognized that, in the absence of a specific statutory exception, the recovery would be taxable

* The tax benefit rule was first rejected by the Board of Tax Appeals (*Lake View Trust & Savings Bank* v. *Commissioner*, 27 B. T. A. 290) but later accepted in part on the strength of a ruling by the General Counsel of the Bureau approving it with respect to bad debt recoveries. G. C. M. 18525, 1937–1, Cum. Bull. 80; G. C. M. 20854, 1939–1 Cum. Bull. 102. *Central Loan & Investment Co.* v. *Commissioner*, 39 B. T. A 981. Although these rulings have since been revoked as inconsistent with fundamental law (G. C. M. 22163, 1940–2 Cum. Bull. 76), the Board has continued to apply the tax benefit rule. *Citizens State Bank* v. *Commissioner*, 46 B. T. A. 964.

as income. The recommendation was based upon a weighing of conflicting considerations: on the one hand, the hardship which the application of the rule in bad debt cases had caused in certain cases; on the other hand, the administrative difficulties, serving to impede tax collection, which are produced by any departure from the annual system of taxation. On balance, it was thought that as a legislative matter, the former should prevail.[9] In their reports endorsing the measure,

[9] Statement of Randolph Paul (Hearings before the Committee on Ways and Means, House of Representatives, 77th Cong., 2d Sess., Vol. 1, pp. 80, 88):

"(c) *Recoveries of bad debts and taxes.*—If a taxpayer who has taken a bad debt deduction later receives payment of such debt, such payment must be included in his income even though he obtained no tax benefit from the deduction in the prior year. While this result is theoretically proper under our annual system of taxation, it may produce severe hardships in certain cases through a distortion of the taxpayer's real income. At the same time, any departure from our annual system of taxation always produces administrative difficulties which serve to impede the collection of taxes.

"It is believed that the hardships can be removed and the administrative difficulties kept to a minimum by excluding from income amounts received in payment of the debt to the extent that the deduction on account of the debt in the prior year did not produce a tax benefit. The troublesome question whether a benefit resulted should be determinated pursuant to regulations prescribed by the Commissioner with the approval of the Secretary. It is also suggested that this treatment be extended to refunds of taxes previously deducted."

both the Senate Finance Committee and the House Ways and Means Committee stated expressly that the section provided (S. Rep. No. 1631, 77th Cong., 2d Sess., p. 79; H. Rep. No. 2333, 77th Cong., 2d Sess., p. 69)—

> for the exclusion from gross income of amounts *otherwise includible in gross income* which are attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent that such debt, tax, or delinquency amount did not operate to reduce the income tax liability of the taxpayer for any prior taxable year. [Italics supplied.]

Two points are plain: (1) Congress regarded such recoveries as income, whether or not there was a prior tax benefit, in the absence of a specific legislative change. (2) Congress intended to change the rule only with respect to those specific situations covered by Section 116. The instant case, of course, does not come within these exceptions. The legislative history of the amendment plainly bears against the judicial adoption of the tax benefit theory.

As Mr. Paul's statement recommending adoption of Section 116 points out, any departure from our annual system of taxation always produces administrative difficulties which serve to impede the collection of taxes. The present liberal provisions for loss carry-over and carry-back, and the provisions of Section 116 have necessarily

added substantially to the administrative burdens.[10] It is for Congress to determine whether it would be sound tax policy further to increase that burden by enlarging the scope of Section 116 to cover other situations as well. It is not a question for judicial decision. See *Burnet* v. *Sanford & Brooks, supra,* p. 367.

4. If the tax benefit rule were judicially adopted, the question would then arise of how it should be determined. The problem and its implications are themselves a persuasive argument against the theory. See *Helvering* v. *State-Planters Bank & Trust Co., supra,* p. 48.

The view taken by the Board of Tax Appeals was that there is a tax benefit if, and to the extent that, the deduction offsets gross income. Whether or not there is such an offset is ascertained by assuming that the deduction in issue was the last deduction taken on the return. Thus, the Board treats the deduction as having been of no tax benefit to the extent that it does not exceed the net loss. Unless the recovery is greater than that amount it is held not taxable.

The taxpayers enlarge upon the theory. They contend that the test is whether the loss reduced the amount of tax dollars which they were required to pay in the earlier year. Harwick, it

[10] Some of the complexities of the problem can be seen from an examination of the regulations adopted under Section 116. See Regulations 103, Section 19.22 (b) (12)–1, as added by T. D. 5288, 1943–15 Int. Rev. Bull. 2.

will be recalled, had net income in the earlier year after deduction of the loss, but he also had available certain credits against net income which relieved him of any tax liability. The argument is that the deduction produced no benefit to the extent that it could have been eliminated from the return and the credits would still have sufficed to prevent any liability. (Taxpayers' Br. 30.) Thus, the proceeds of the subsequent recovery would be taxable only insofar as they were in excess of an amount which could have been added to income in 1930 without producing any tax liability.[11]

If the tax benefit rule were adopted, however, it is difficult to see the basis for requiring more than that the deduction offset gross income. The argument for the rule is based on the principle that cost must be recouped before taxable gain is realized upon disposition of an asset. Adoption of the rule, as we analyze the problem, would result from a conclusion that the statutory right to a prior deduction does not suffice to satisfy the requirement. It would be entirely wrong, however, then to go so far as to say that the prior

[11] The same issue is also raised in the *John V. Dobson* case. There, the taxpayer's recovery exceeded the net loss in the prior years by approximately $2,000, and the Board held the recovery taxable to this extent. But if Dobson's subsequent recovery were added back to the loss in the prior year, there would have been no tax liability since the resulting net income would be offset by available credits. (Br. 43.)

deduction must result in a dollar tax advantage. On this theory, for example, the actual proceeds received by the taxpayers from the sales of their shares in prior years would not constitute a recovery of capital, if their exclusion from gross income did not result in a dollar tax advantage because of deductions or credits otherwise available to the taxpayers. Carried to its logical limits, this theory would treat prior deductions as not having resulted in "tax benefits" *pro tanto*, where they in fact reduced taxable net income in a year when the tax rates were lower, or when the taxpayer's net income did not reach the higher surtax brackets applicable to him in the later year. We think the most that could be expected under the tax benefit rule would be an actual exclusion by means of the deduction from the income which Congress undertakes to tax.[12]

How, then, is it determined whether, and to what extent, there has been such an exclusion? The Revenue Act of 1928 follows the usual pattern of allowing various deductions from gross income of which the loss deduction is one. Section 23. In computing the tax upon the net income thus

[12] As the taxpayers point out, the special relief provisions of Section 116 of the Revenue Act of 1942, which we have discussed above, adopted the test of whether the prior deduction had resulted in a reduction of the taxpayer's tax. But such legislative action is not evidence that the same result properly would follow from the development of a tax benefit theory judicially.

determined, specified credits are then allowed for the purpose of the normal tax, but not for the surtax. Revenue Act of 1928, Section 25; see also the provisions of Section 31 providing for an earned income credit.

Whatever the similarity in practical effect between a deduction and a credit in a given case, the statute plainly distinguishes between the two. The deductions offset the gross income. The credits are subsequently taken into account in the computation of the tax. The statutory scheme treats the deductions as offsetting the gross income, not the credits. We can perceive no basis for treating the credits as having this effect.

The Board of Tax Appeals would not go this far. But confronted with the fact that the aggregate of all available deductions exceeded the gross income, it assumed, as we have said, that the loss deduction was the last to be deducted. As between the various deductions, however, the statute provides no basis for an inference that any one is taken before or after the other. In the circumstances, it seems apparent that each of the deductions must be taken to have shared proportionally with its fellows in producing the net loss. Cf. *Butler Bros.* v. *McColgan*, 315 U. S. 501, 508, 509. We think that if the tax benefit rule were adopted, calculation of the benefit and lack of benefit would have to proceed on that basis.[13]

[13] This point was noted, but not reached, in *Virginian Hotel Corp.* v. *Helvering*, *supra*, in view of the stipulation of

But this leads to another complication. In the enactment of Section 116 of the 1942 Act, Congress indicated that it wished the bad debt, tax and delinquency amount deductions to be deemed to be the last deductions or credits taken. They will be treated as having been of no tax benefit if the taxpayer could have refrained from deducting them without affecting his tax due for the year of deduction. S. Rep. No. 1631, 77th Cong., 2d Sess., p. 80. See Regulations 103, Section 19.22 (b) (12)–1, as added by T. D. 5288, 1943–15 Int. Rev. Bull. 2.[14] The clash inherent between this statement of legislative intention respecting these three types of deductions and the judicial adoption of the tax benefit rule with respect to situations not covered by the Congressional enactment, is evident: The potential conflict is an objection in itself to an attempt to adopt such a rule by judicial action. It is substantial additional evidence that Congress regarded the tax benefit rule as inapplicable in any situation except that expressly dealt with by it.

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the parties in that case. See footnote 8 of the Court's opinion.

The taxpayers do not advance their case by arguing that the burden is with the Government to show that it suffered loss or damage from the prior deduction. (Br. 27–28.) The question, as we view it, is one of basis. It can be argued at least with equal force that the burden is on the taxpayers to establish the basis for the claims, and that in this connection they must show that their investment was not recouped through the prior deductions.

[14] These amendments were also made applicable to prior years. T. D. 5288, Par. 2.

II

THE COURT BELOW CORRECTLY HELD THAT THE PROCEEDS WERE TAXABLE AS ORDINARY INCOME AND NOT AS GAINS FROM THE SALE OR EXCHANGE OF A CAPITAL ASSET WITHIN THE MEANING OF SECTION 117 (a) (4) OF THE INTERNAL REVENUE CODE

The taxpayers make the alternative argument that if, as the Government contends, the proceeds of the settlements constituted income, they are not taxable as ordinary income but as long-term capital gain from the "sale or exchange" of a capital asset held for more than 18 months within the meaning of Section 117 (a) (4) of the Internal Revenue Code (Appendix, *infra*). The taxpayers would thereby be entitled to the benefit of the limitations placed upon the taxation of such gains by Section 117.

The court below correctly sustained the Board in rejecting this contention. Unlike Section 111 (a) of the Code, to which we have previously referred, Section 117 (a) (4) refers only to the "sale or exchange" of a capital asset and not broadly to the sale "or other disposition of" property. Cf. *Stokes* v. *Commissioner*, 124 F. 2d 335, 337–338 (C. C. A. 3d). This Court has made it clear that the terms "sale" and "exchange," as used in Section 117, must be given their ordinary

meaning. *Helvering* v. *Flaccus Leather Co.*, 313 U. S. 247; *Fairbanks* v. *United States*, 306 U. S. 436. Neither term, as the court below aptly points out (R. 136), is appropriate to characterize a settlement of a claim. Cf. *Helvering* v. *Flaccus Leather Co.*, *supra*, p. 249. The claim is not sold; it is extinguished. See *Hale* v. *Helvering*, 85 F. 2d 819 (App. D. C.).

There is no warrant, moreover, for relating these recoveries back to the sales of the stock in 1930 and 1931, as the taxpayers contend (Br. 34–36). To be sure, if the shares had not been sold in 1930 and 1931, any recovery from the assertion of a claim against the original vendors in 1939 would not have been income in that year unless it exceeded the cost basis. The sales in 1930 and 1931 resulted in the receipt of cash and the right to the loss deductions in those years which in turn meant that the claims would have a zero basis in 1939. In this sense, the prior sales may have been the *sine qua non* of the gain in 1939. Nevertheless the sales and the subsequent settlement were two entirely separate and distinct transactions. We think it would distort the facts and unduly stretch the normal connotation of the statutory language to conclude that the gain in 1939 was "from" the 1930 and 1931 sales.

CONCLUSION

The judgment of the Court below was correct and should be affirmed.

Respectfully submitted.

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OCTOBER 1943.

APPENDIX

Internal Revenue Code (1939):

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

* * * * * *

(U. S. C. 1940 ed., Title 26, Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * * *

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * *

(U. S. C. 1940 ed., Title 26, Sec. 23.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(U. S. C. 1940 ed., Title 26, Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

U. S. C. 1940 ed., Title 26, Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws. * * *

* * * * * *

(U. S. C. 1940 ed., Title 26, Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (*l*);

(2) *Short-term capital gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * * *

(U. S. C. 1940 ed., Title 26, Sec. 117.)

Sections 22 (a), 23 (e) (2), and 112 (a), Revenue Act of 1928, c. 852, 45 Stat. 791, are identical with the corresponding sections of the Internal Revenue Code.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

* * * * * *

(e) *Determination of gain or loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in sections 111, 112, and 113.

* * * * * *

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

(2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws; * * *

* * * * *

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; * * *

* * * * *

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